

Revenue Review

Tennessee Department of Revenue

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REVENUE ...
Working For You



January 2005

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Contact Us:

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Public Law 86-272 Does Not Create a Safe Harbor for Tennessee Franchise Tax

The Attorney General's Office issued an opinion on Nov. 8, 2004, concerning whether 15 U.S.C. § 381(a) (better known as Public Law 86-272) exempts an entity conducting business in Tennessee from franchise tax liability if the entity's only business activity in Tennessee is the solicitation of orders for tangible personal property which are approved and delivered from locations outside Tennessee.

The Attorney General concluded that Public Law 86-272 applies only to state taxes measured by net income. Thus, Public Law 86-272 does not apply to the Tennessee franchise tax, which is measured by a taxpayer's net worth. Tenn. Code Ann. Section 67-4-2101, et seq. A copy of the opinion may be obtained at www.Tennessee.gov/revenue.

Taxpayers who have not registered with the Department of Revenue for Tennessee franchise tax based on Public Law 86-272 should register immediately. Returns must be filed with the department on or before the 15th day of the fourth month following the close of the taxpayer's tax year. Returns are due from calendar year taxpayers by April 15. A six-month extension in which to file the return will be granted if the taxpayer has paid 90% of its tax liability on or before the original due date of the return. Taxpayers with a combined franchise tax and excise tax liability of \$5,000 or more must make quarterly estimated payments equal to 25% of the taxpayer's prior year liability or 25% of the taxpayer's current year liability, whichever is less.

Taxpayers may now register and make estimated payments and extension payments online by visiting the department's Web site.

Enhanced Compliance Efforts: Use Tax and Business Tax

Discovering Unpaid Use Taxes

The department is in the process of contacting many professional service firms to request a review of their records for use tax liabilities. When a professional service firm purchases equipment or supplies outside Tennessee without the payment of tax, use tax is due on the cost of the equipment or supplies. The first firms to be contacted include dentists and doctors; however, other firms will be contacted in the coming months.

Another area of use tax noncompliance is underreporting the sales price on the transfers of vehicles and boats between individuals. When a vehicle or boat is transferred

from one individual to another individual for less than fair market value, the application filed with the county clerk is sent to the department for review. If it is determined that the failure to report and pay the total tax is the result of fraudulent actions, a penalty of 100% is assessed on the underpayment of tax. Owners who may have paid less tax than was owed on a vehicle or boat purchase are encouraged to come forward voluntarily. Information on this process can be obtained by contacting the Discovery Unit at (615) 532-6074.

Business Tax Update

The department is increasing our efforts to identify and collect delinquent business taxes. We will be contacting many companies that have not filed business tax returns for past years. Working together with county and city tax officials, the department will promote compliance with business tax laws and encourage companies to pay all past business tax liabilities.

The Tennessee Court of Appeals Reaffirms Decision Related to Franchise and Excise Taxes

In the case where two business entities merge, it has been a long-standing position of the department that net operating losses of a predecessor corporation cannot be carried over by a successor corporation. In other words, if ABC Corporation has \$10 million in losses and merges into XYZ Corporation so that XYZ Corporation is the surviving entity, the \$10 million in net operating losses cannot be claimed by XYZ. See Franchise/Excise Tax Rule 21 and Tenn. Code Ann. Section 67-4-805. The department successfully litigated this position in *Little Six Corporation v. Johnson*, No. 01-A-01-9806-CH-00285, 1999 WL336308 (Tenn. Ct. App. May 28, 1999).

The Tennessee Court of Appeals recently reaffirmed the *Little Six Corporation* opinion in the case of *AT&T Corp. v. Johnson*, No. M2003-00148-COA-R3-CV, slip op. (Tenn. Court App. April 8, 2004) *permission to appeal denied* (Tenn. Sept. 7, 2004). In this case, AT&T created AT&T Information Systems (Information Systems) in 1982 in order to comply with a 1980 federal regulatory ruling. It later merged Information Systems back into AT&T and claimed that during this time, the "taxpayer" really was always AT&T. After the merger, AT&T, the surviving entity, attempted to deduct net operating losses incurred by Information Systems. The department disallowed the deductions.

The Tennessee Court of Appeals Reaffirms Decision Related to Franchise and Excise Taxes, continued

Based on the *Little Six* case, the Court held that the two entities were separate corporations for purposes of Tennessee Franchise and Excise Tax Law and that AT&T was therefore not allowed to deduct net operating losses incurred by its predecessor, Information Systems.

AT&T also sought to claim industrial machinery credit for its 1993 through 1996 computer and software purchases, despite the fact that it did not qualify for the jobs tax credit set forth at Tenn. Code Ann. Section 67-4-908. The Court said that the statutes were clear that in order for computers, networks, and software as defined in Tenn. Code Ann. Section 39-14-601, as well as their peripheral devices, to qualify for the industrial machinery credit, they had to be purchased in the process of making the "required capital investment" described in Tenn. Code Ann. Section 67-4-908.

Voluntary Disclosure Program

What can a business or consumer do upon discovering responsibility for paying a tax that has not been paid? How can an out-of-state company without physical presence voluntarily register to collect Tennessee sales tax?

The department offers a voluntary disclosure program whereby a business or consumer can report past liabilities and register for Tennessee's taxes. Voluntary disclosure agreements can be entered into for any tax administered by the department. These agreements are mutually beneficial to the taxpayer and the state. Benefits for the taxpayer include the limitation of prior liability and abatement of penalty. The state benefits by adding taxpayers to our tax rolls.

Many out-of-state retailers that do not have traditional nexus have used this program. It is also beneficial to businesses that need to report a past liability when registering. For example, a professional service firm that does not sell tangible personal property may not need to be registered for sales tax purposes. However, if the firm purchases equipment or supplies from outside Tennessee without payment of tax, use tax is due on these purchases.

In order to be eligible to enter into an agreement, the taxpayer must not have been contacted by the department regarding the applicable tax prior to submitting a written request for an agreement. The request can be submitted by a third party representing the taxpayer and does not need to disclose the identity of the taxpayer. Once the letter is received, the department will draft an agreement and send it to the taxpayer, or the third party, for approval.

Letters requesting voluntary disclosure agreements should be sent to the Tennessee Department of Revenue, Discovery Unit, P.O. Box 190644, Nashville, TN 37219. For further information contact the Discovery Unit at (615) 741-8319.

Are you a registered taxpayer? If YES, we need your tax contact's e-mail address, so we can e-mail information in the future. Call toll-free (800) 342-1003; Nashville-area and out-of-state callers, dial (615) 253-0600.

Penalty Provisions

Tenn. Code Ann. Section 67-1-804 provides for the assessment of delinquency, fraud and negligence penalties.

A delinquency penalty is imposed for the late filing of a tax return and for late payment of taxes owed the state. The penalty is computed at a rate of 5% per month, or any portion of a month, from the due date until the date the taxes are paid, up to a maximum of 25% of the unpaid amount. The minimum penalty is \$15.

A 10% negligence penalty can be applied if a taxpayer is found to be negligent. Negligence includes, but is not limited to, any failure to make a reasonable attempt to comply with the provisions of the statutes relating to any tax collected or administered by the commissioner.

One-hundred percent fraud penalty may be assessed when a person fails to report and pay the total amount of taxes due and such failure is due to any deceitful practice or willful intent to evade the tax.

The most recent penalty provision enacted by the legislature is a 50% negligence penalty. Public Chapter 786 of the 2004 Public Acts amended Tenn. Code Ann. Section 67-1-804(b)(2) to provide that any person who fails to disclose any transaction in the manner prescribed by this title and fails to report and pay the total amount of taxes due, if such failure is determined by the commissioner to be due to negligence, will be penalized in the amount of 50% of the underpayment.

Currently, there are two instances where the 50% penalty might be applicable. First, taxpayers who fail to disclose intangible expenses paid to affiliates as required by Tenn. Code Ann. Section 67-4-2006(d)(2) will be assessed the 50% negligence penalty on any additional excise tax due as a result of this failure to disclose. A disclosure form will be available for taxpayers to complete when filing their franchise and excise tax returns. This disclosure requirement is effective for all tax periods beginning on or after Jan. 1, 2004.

In addition, taxpayers who fail to report a capital gain on the sale of an asset, if the asset was sold within 12 months as provided by Tenn. Code Ann. Sections 67-4-2006 and 67-4-2007, may also be assessed the 50% negligence penalty on the additional excise tax.

Electronic Commerce Mandates

Tenn. Code Ann. Section 67-1-703(b) allows the commissioner of Revenue to require taxpayers remitting tax payments of \$10,000 or more to make those funds immediately available to the state on the day the tax is due. The commissioner may determine how taxpayers will make these payments. Payment must be made electronically to guarantee the funds will be available immediately. The Department of Revenue offers two payment options, Automated Clearing House (ACH) debit and ACH credit. A third payment option, federal wire transfer, may only be used on an emergency basis.

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Technical Questions

Q: Is labor taxable for sales or use tax purposes?

A: Labor charges for the installation or repair of tangible personal property, as well as the parts or materials, are subject to the tax. Charges for labor to install or repair real property are not subject to the sales tax.

Q: What must I do to qualify for a family-owned, non-corporate exemption from franchise-excise tax?

A: An entity which believes it is exempt under the family-owned, non-corporate entity exemption should send a letter to the department's Taxpayer Services Division with a statement to that effect. An officer or owner of the entity must sign the letter. The letter should be mailed Tennessee Department of Revenue, Attn. Taxpayer Services, 500 Deaderick St., Nashville, TN 37242.

Two criteria must be met in order to qualify for the family-owned non-corporate exemption:

- 1) At least 95% of ownership must be held by family members, and
- 2) Substantially all (66.67%) of the activity of the entity is either:
 - a) The production of passive investment income, or
 - b) The combination of the production of passive investment income and farming.

"Passive investment income" is defined as gross receipts derived from royalties, rents, dividends, interest annuities, and sales or exchanges of stock or securities.

"Farming" is the growing of crops, nursery products, timber or fibers, such as cotton, for human or animal use or consumption; the keeping of horses, cattle, sheep, goats, chickens or other animals for human or animal use or consumption; or the keeping of animals that produce products, such as milk, eggs, wool or hides for human or animal use or consumption; or the leasing of the land to be used for the purposes herein described.

Q: How do I terminate or withdraw my corporation's charter?

A: File a final franchise and excise tax return and mark the "Final Return" box located at the top right of the tax return. The final return should include a schedule of liquidation, distribution or disposition of all assets. The department will review the corporate account for release of liability. Once all liabilities are satisfied, a tax clearance certificate is issued by the Department of Revenue. The tax clearance certificate, along with a letter of dissolution from the corporation, must be submitted to the Tennessee Secretary of State.

Q: Can franchise and excise taxes be prorated for a short-period (less than 12 months) return?

A: Franchise taxes can be prorated for the number of days covered by the tax return. The excise tax may not be prorated. Annualization of rent paid is required when determining the minimum measure (Schedule G) of the franchise tax base.

Holiday Shopping Reminder: File Consumer Use Tax Online This Year

Holiday shopping is upon us. As shoppers search for the perfect gifts, the Tennessee Department of Revenue reminds all online shoppers, mail-order customers, and out-of-state bargain hunters that they can *e-file* their consumer use tax, the counterpart to the state's sales tax. The Department of Revenue offers online filing of consumer use tax via its Web site, www.Tennessee.gov/revenue.

"The Department of Revenue is becoming a 'digital department' by adding online tax-filing options like the consumer use application we launched last December," said Revenue Commissioner Loren L. Chumley. "We encourage our customers to utilize all of our convenient and secure e-filing options to voluntarily comply with Tennessee's tax laws."

What is the consumer use tax?

Contrary to popular opinion, online and catalog sales are subject to use tax. This tax has been on the law books since 1947 and is the same rate as the sales tax. When someone buys merchandise online or through a catalog and the seller of the merchandise does not collect sales tax, the consumer who bought the item has a legal obligation to file and pay use tax on the merchandise. And, purchasing merchandise outside of Tennessee, whether done physically or electronically, will not exempt someone from paying use tax if an equal amount of sales tax was not paid to another state at the time of purchase.

Save the Date: Upcoming Seminars and New Business Workshops Across the State

Visit our Web site, www.Tennessee.gov/revenue, and click on "Seminars, New Business Workshops and Speakers" to learn more about these and other upcoming seminars and workshops.

January

- Jan. 12** – New Business Workshop, Chattanooga
- Jan. 13** – New Business Workshop, Johnson City
- Jan. 13** – New Business Workshop, Memphis
- Jan. 19** – New Business Workshop, Knoxville
- Jan. 25** – New Business Workshop, Nashville

March

- March 9** – New Business Workshop, Chattanooga
- March 10** – New Business Workshop, Johnson City
- March 10** – New Business Workshop, Memphis
- March 16** – New Business Workshop, Knoxville
- March 22** – New Business Workshop, Nashville

Online Sales Tax Filing Statistics

| Month | Number of Returns | Total of Amount Collected |
|----------------|-------------------|---------------------------|
| August 2004 | 9,798 | \$109,577,447 |
| September 2004 | 10,025 | \$110,326,564 |
| October 2004 | 10,915 | \$113,319,343 |

A Note From Commissioner Loren L. Chumley



In making budget preparations for the upcoming fiscal year, our staff has been reviewing performance statistics for the fiscal year ending June 30, 2004. Sales tax returns filed electronically improved from 6.75% of total returns in FY '03 to 11.93% in FY '04 and are at 19.89% for the first four months of FY '05. In October 2004, 72% of new applications for registration were made through our Web portal. Self-service features and quality control initiatives resulted in an 11% reduction in phone calls

to our call center – that is 55,842 fewer calls during the last fiscal year. Finally, technology coupled with stepped-up collections efforts have yielded an 11.25% reduction in tax periods in a delinquent status.

Many of these improvements allow us to reduce certain costs and allow us to better focus our limited resources on education and compliance initiatives.

With the new year comes the administration of the new Unauthorized Substances Tax that was passed by the General Assembly with an effective date of Jan. 1, 2005. This is a state excise tax levied on controlled substances (marijuana, cocaine, crack, methamphetamine, etc.) and certain illicit alcoholic beverages (untaxed liquors and spirits). Seventy-five percent of the tax proceeds are returned to the state or local law enforcement agency that conducted the investigation that led to the assessment. The proceeds are to be used by those law enforcement agencies to combat, prevent and reduce drug crimes. The remaining tax proceeds will be credited to the state's general fund.

In addition, we are concentrating many resources on implementing the new Streamlined Sales and Use Tax laws which take effect on July 1, 2005. We plan to devote an upcoming issue of Revenue Review to this subject. Much more information on this subject may be found on our Web site.

Filing Frequency Analysis

Each January, the Department of Revenue reviews all active sales or use tax accounts to determine appropriate filing periods, whether annual, quarterly, monthly, or not required. Taxpayers whose filing frequencies are changed will be notified.

Tenn. Code Ann. Section 67-6-505 authorizes the commissioner of Revenue to require taxpayers to file their taxes less frequently than monthly when it is in the state's best interest. Also, Tennessee Sales or Use Tax Rule 1320-5-1-.63(4) authorizes the commissioner to require dealers with average gross monthly sales of \$400 or less in tangible personal property or \$100 or less in taxable services to pay sales tax to their suppliers in lieu of registering for sales or use tax purposes.

October Collections

October 2004 collections by the Department were \$677,516,280, an increase of \$34,066,250 or 5.3% over October 2003 collections. Sales and use tax collections were \$501,202,288, up \$18,860,319 or 3.9% over October 2003 collections. Consumer use tax collections were up 142.1% over collections in October 2003. Franchise and excise tax collections were \$22,021,891, down \$19,244,690 or 693% when compared to October 2003 collections. Inheritance, gift and estate tax collections were \$6,316,241, declining \$1,678,375 or 21% from last year's collections.

Contact Us

- Taxpayer hot line: Statewide toll-free (800) 342-1003; Nashville-area and out-of-state callers should call (615) 253-0600.
- Online tax help by e-mailing TN.Revenue@state.tn.us.
- Streamlined Sales Tax hot line: In Tennessee, call (877) 250-2299. In Nashville and outside Tennessee, call (615) 253-0752.
- Streamlined Sales Tax online assistance by e-mailing Streamlined.Salestax.QandA@state.tn.us.
- Tax practitioner hot line: Statewide toll-free (800) 387-8395; Nashville-area and out-of-state callers should call (615) 253-0700.
- Local government hot line: (866) 562-2549.
- E-mail updates: Visit our Web site, www.Tennessee.gov/revenue, to subscribe to Revenue-News or lists dedicated to county clerks and city officials.
- Electronic commerce hot line: Statewide toll-free: (866) 368-6374. Nashville-area and out-of-state callers should dial (615) 253-0704.
- Tax fraud hot line: To report tax fraud, call (800) FRAUDTX (372-8389).

Electronic Commerce Mandates, continued

As of the January 2004 tax period, Tenn. Code Ann. Section 67-6-504 requires taxpayers to remit sales or use tax payments electronically, or those who voluntarily choose to do so, to electronically file returns associated with mandatory electronic payments. Electronic tax return filing can be initiated using Electronic Data Interchange (EDI) software. Software can be purchased from approved software vendors or Internet tax service providers.

Contact information for approved software vendors or Internet tax service providers, as well as ACH credit and debit options, is available from the department's Electronic Commerce Unit at (866) 368-6374 [in state] or (615) 253-0704 [out-of-state].

The Department of Revenue also offers all taxpayers the option of filing electronically through the state of Tennessee's Web portal. We believe this filing option is the most efficient, most convenient, and most secure option for taxpayers and the most cost-efficient method of processing returns for state government. Best of all, this option is free to users.



Authorization number 347193: 128,000 copies: November 2004. This public document was promulgated at a cost of \$0.049 per copy, Tennessee Department of Revenue.